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RR RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHRL #2014/01 3061643
ZNR UUUUU ZZH
R 021643Z NOV 07
FM AMEMBASSY BERLIN
TO RUEHC/SECSTATE WASHDC 9690
INFO RUEHC/DEPT OF LABOR WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCNMEM/EU MEMBER STATES
RUEHBS/USEU BRUSSELS
RUCNFRG/FRG COLLECTIVE

UNCLAS SECTION 01 OF 03 BERLIN 002014

SIPDIS

STATE FOR DRL/ILCSR, EUR/ERA AND EUR/AGS; LABOR
FOR ILAB
(BRUMFIELD); TREASURY FOR OASIA
USEU FOR PETER CHASE, JULIE NUTTER, BARBARA
MATTHEWS

SIPDIS

E.O. 12356: N/A
TAGS: [ECON](#) [ELAB](#) [EFIN](#) [PREL](#) [PGOV](#) [GM](#)
SUBJECT: LABOR REFORMS IN GERMANY: A THREAT TO
ECONOMIC RECOVERY?

REF: (A) BERLIN 2004; (B) BERLIN 1977

Summary

11. In the last few weeks, much has been written about the SPD's new program to roll back labor reforms in Germany, with the "Financial Times" characterizing them as a German retreat from economic reform. Whether the Beck proposals or a government counter-proposal can be contained as a piece-meal package or represents a wider trend remains to be seen. The question is one of both perception and reality. The reality is that the reform rollbacks - primarily related to extending labor unemployment benefits - would have little immediate impact on the fundamental dynamics behind Germany's economic growth. A greater threat stems from the perception among the business community and others that Germany is beginning to turn its back on reform (Ref. A). Nonetheless, Germany's economic recovery will continue to be much more significantly influenced by the mega-developments in the global economy and by its own fundamental restructuring. Ultimately, both major political parties recognize that jeopardizing Germany's steady economic recovery is not in their or Germany's longer term national interest.

What is Germany Trying to Reform?

12. Social perceptions drive the current debate on labor market rollbacks. At the heart of the matter is the broad perception among the population that the so-called Hartz labor market reforms (targeted at Germany's inflexible labor market) are mean-spirited and disadvantage older workers in particular. The panacea - extension of unemployment benefits to workers over the age of 50 - is seen to be relatively cost neutral as well socially advantageous. While the proposals can be characterized as a rollback, they represent but one piece of a broader economic reform agenda (known as Agenda 2010) that touched on a significantly broader set of issues than just labor issues, for instance, tax reform.

Though there is active discussion on increasing the number of rollbacks to the Hartz labor market reform package, there has been no discussion in Germany with regard to dismantling this broader package of reforms.

Labor Reforms: What Has Been Their Impact?

¶3. The Hartz package changed the maximum duration of unemployment benefits in an effort to ease the pressure on pension insurance funds and to reduce non-wage labor costs. The package also sought to remove the disincentive for older workers to accept jobs they considered less attractive and to discourage early retirement at the taxpayer's expense. Ironically, the current rollback proposals come just at a time when the Hartz reforms are bearing fruit. When Chancellor Schroeder first presented his Agenda 2010 to the Bundestag on March 14, 2003, Germany had 4.6 million unemployed; today the number is 3.45 million, the lowest level in twelve years.

¶4. The cut in unemployment benefits for older jobseekers has contributed to a changed mentality by giving strong incentives to proactively search for work, according to the German Institute for Economic Research and the Center for European Economic Research. Long-term unemployment has also fallen as flexibility increased, according to a recent study of the Federal Employment Agency's (BA) research Institute, IAB. One in five companies polled reported jobseekers were

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more willing to work for lower wages, accept irregular work hours and take on long commutes. Even for hard to fill jobs, companies are finding applicants more easily. This is where the proposed roll-back that the SPD proposes is likely to do most harm. It may halt or even reverse this extremely positive trend.

Business Community Concerned

¶5. The SPD proposals have concerned the German business community. Ludwig Braun, president of the German Chamber of Industry and Commerce (DIHK), commented that any extension of benefits would give the unemployed "wrong incentives" and "increase the risk" for the labor market. Others warn against a general "slide back" into past patterns of behavior. The President of Germany's Federation of German Industries, Michael Thumann, called upon the membership of his organization to defend the reforms in meetings with government and parliamentarians. The overall effect of the proposed changes on the current upswing is, however, likely to be limited.

Economic Boom above all a Business Success Story

¶6. Holger Schmieding, Bank of America's Head of European Economics, estimates that the entire Agenda 2010 reforms (which contains much more than the labor reform package now under debate) contributed about one third to the current growth rate. A dent in global economic activity could be as damaging since the current upswing is driven so much by global demand for German capital goods. Moreover, German business - with cooperation from labor unions - has done its part. In recent years many German companies have

realigned their strategies, tapped into new production and sales markets, and slashed costs. While unit labor costs in the Euro area climbed by almost 10% between 2000 and 2006, they steadily declined in Germany as a result of wage restraint, longer working hours and more flexible labor input. The Hartz reforms may have reinforced some of the wage restraint, but they were not the engine; the wage restraints started already in the mid-1990's - eight years before the Hartz reforms were implemented.

17. Germany's heightened price competitiveness is accompanied by regained technological prowess. Among the EU-15 Germany can boast the highest share, 65%, of innovative industrial enterprises. The broad range of high-grade, innovative German capital goods meets increasing demand from the high-growth emerging markets. Germany is the only big industrial nation to have maintained its share of the world market. Last year alone German shipments soared by 12.5% in real terms, while 2007 is predicted to turn in a similar increase. The ratio of exports to German GDP now stands at 45% - astoundingly, over 10 percentage points more than in 2000. As analysts across the board agree, the effect of the proposed labor changes is dwarfed by the threat of sluggish U.S. and global economic growth, the surge of the Euro and continuously rising oil prices.

Comment

18. Since 2006, Germany has been registering rates of growth last seen in the 1998-2000 period. After years of stagnation (between 2001 and 2005 the economy grew by a mere half percent per annum) - Germany is no longer the "sick man" of Europe, but rather by some measures its healthiest partner. Business, through painful restructuring, the opening of new markets and the

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development of innovative products is the major force behind the success. Wage restraint on the part of labor added substantially to the decline in unit labor costs. While government policies have bolstered the upswing, they have only contributed to the forces already driving growth. The danger of the current rollbacks thus lies more in the signal they send to investors - i.e. that Germany is now less serious about reform - than to their immediate impact on the economy.

TIMKEN JR